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Canada and a Mexico-United States Trade Agreement

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WORKING PAPER

CANADA AND A MEXICO-UNITED STATES TRADE AGREEMENT

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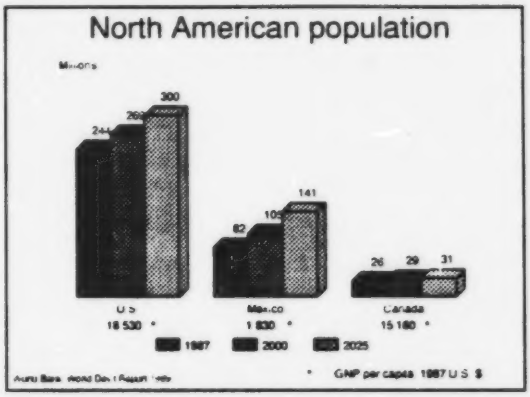
I. Introduction

On June 10, 1990, Presidents George Bush and Carlos Salinas de Gortari announced that they had determined that a "comprehensive Free Trade Agreement" was the best vehicle to achieve a vigorous partnership for sustained economic growth that will open markets so that trade and investment can expand further. The two presidents then directed their two trade ministers to begin the consultations and preparatory work needed to initiate negotiations on a free trade agreement. They were to report back to the two presidents before their next meeting in December of this year.



This announcement ends months of speculation as to whether or not the U.S. and Mexico would initiate a process towards a free trade agreement. While the announcement is still some steps removed from the actual launching of negotiations and is only a call for a study, it would appear that the interests of Mexico, in particular, but also that of the U.S. are such that it is expected that the report will recommend the launching of negotiations. In beginning first with a study, both parties will have an opportunity to better define the parameters of the negotiations before starting and also begin the actual negotiations after the conclusion of the Uruguay Round of the GATT Multilateral Trade Negotiations.

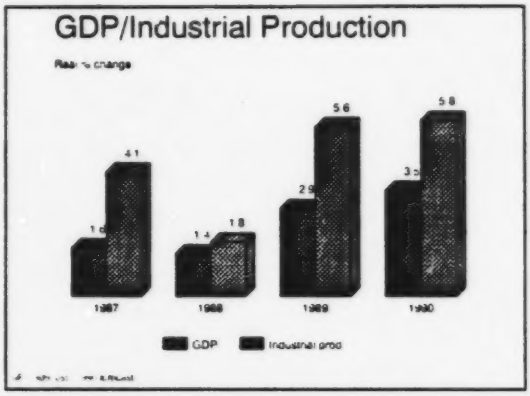
The purpose of this background paper is to focus on the economic implications for Canada should the U.S. and Mexico proceed without Canada or should Canada choose to be directly included. The paper is not intended to be comprehensive or definitive, but attempts to provide an overview of the various economic implications that will need to be taken into account in reaching a decision on Canada's approach to North American freer trade. No attempt is made in this paper to speculate on the scope or nature of any possible trade agreement that might be negotiated (either between the U.S. and Mexico or including Canada), but the general assumption for the purposes of this paper is that what is being explored is a free trade agreement and not a customs union with a common external tariff.

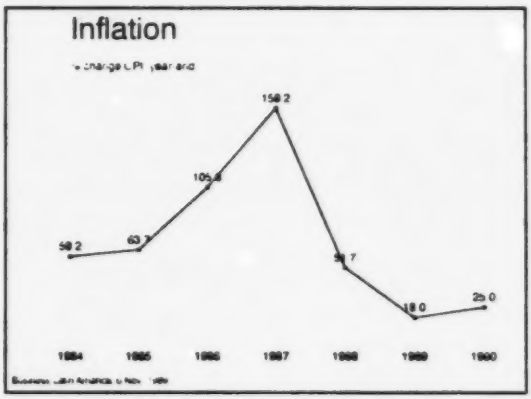
In examining the implications for Canada, the paper begins with a review of why Mexico needs a trade agreement and the extensive economic changes that have taken place over the past four years in Mexico. Next, it briefly examines the interests of the U.S. in a trade agreement with Mexico, focusing on the economic aspects. The third section begins with an overview of Canada's trade with both Mexico and the U.S. and an assessment of how Canada might be affected by an agreement between the U.S. and Mexico. The paper also examines in greater detail the impact of a North American agreement on certain key sectors and on

Canada's markets, not only domestic, but also in the U.S. and Canada's export interests in Mexico. Given that a major reason for Mexico embarking down the path towards free trade is to attract greater foreign investment, an effort is made to examine the potential long term impact on investment flows to both Mexico and Canada. In conclusion, the paper seeks to summarize the main economic issues for Canada.

II. Why Mexico wants a trade agreement

As the smallest, most protected and poorest of the three nations in North America, in economic terms Mexico clearly has the most to gain from greater trade access with the U.S. and Canada. Moreover, further North American trade liberalization is, from a Mexican perspective, the logical consequence of the economic strategy pursued by the Salinas government. This strategy is designed to ensure that Mexico is able to overcome the threats posed to its development by the combined effect of domestic demographic pressures, its large international debt, capital flight and the internationalisation of the world economy. The government's strategy is set out generally in a National Development Plan for 1989-1994 and in 21 sectoral reform programs which stress the on-going opening of trade and investment as vital parts of the drive to modernize the economy.





The government also maintains a package of measures under the so-called Pact for Stability and Economic Growth (PECE) which aims to keep the lid on inflation and stabilize the economy. The PECE includes the following key measures:

- daily mini-devaluations of the peso;
- no wage increases are included in the renewed Pact;
- business and labour agreed to conclude a national accord for improvement of productivity; and
- an upward price adjustment for energy.

Overview of Mexico's economic reforms

IMPORT LIBERALIZATION

- Mexico has joined the GATT, reduced tariffs significantly, harmonized its tariff structure, abolished official prices, and removed most import licensing requirements. All Mexican tariffs are bound; maximum rates are reduced from 100% to 20% and its average tariff rate is only 6%. It has eliminated the import licensing requirement for 95% of its imports.

- **Computers:** All import permits have been eliminated and tariffs have been reduced significantly (5 to 20 percent range, expected to be down to 5% in two years). Producers can import duty free if the end-product satisfies a 30% local content requirement.

- **Pharmaceuticals:** Import permits will be fully eliminated by 1993.

PRIVATIZATION

- By the end of 1989, about 650 state-owned firms had been dismantled, consolidated, or sold.

- **Banking:** The re-privatization of domestic banks was announced on May 2. It is expected that divesture will be phased in and will lead to a mixed system of ownership. Minority foreign ownership is expected to be allowed.

- **Telecommunications:** Shares in Telmex, the national monopoly, will be floated this year. Foreigners will be allowed to purchase up to 49% of the company's shares.

- **Airlines and steel:** Both domestic airlines have been privatized. The government also intends to sell two of the country's largest steel plants.

FOREIGN INVESTMENT

- Restrictions on foreign investments of less than U.S. $100 million have been removed in most industrial sectors if they are found to create local employment and transfer technology.

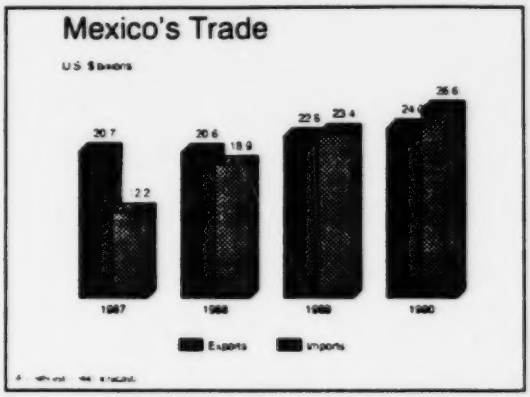
- 100% foreign ownership is now allowed in **mining, auto parts manufacturing,** and **secondary petrochemicals** if the investor provides suitable technology or invests in a company with international balance of payments problems.

INTELLECTUAL PROPERTY

- New regulations have removed limits on royalties, extended the protection of industrial secrets, and simplified the registration and approval of licensing agreements. New patent and trademark legislation is expected in 1991.

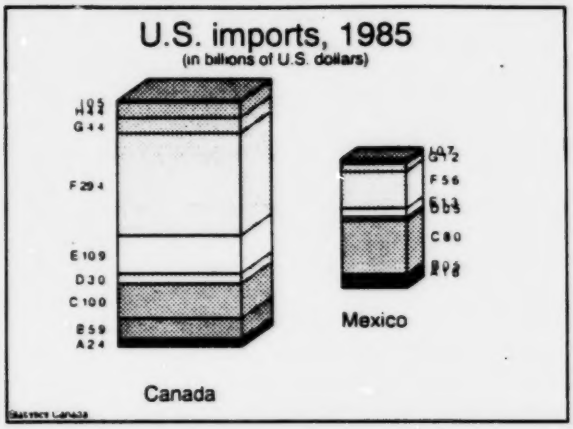
Another essential element of the Salinas economic program fell in place in March 1989 with the successful conclusion of debt re-scheduling negotiations which saw the Mexican debt cut by U.S. $21.38 billion. The agreement is considered by the Mexican government as giving its plans for the modernization of the economy sufficient room to manoeuvre.

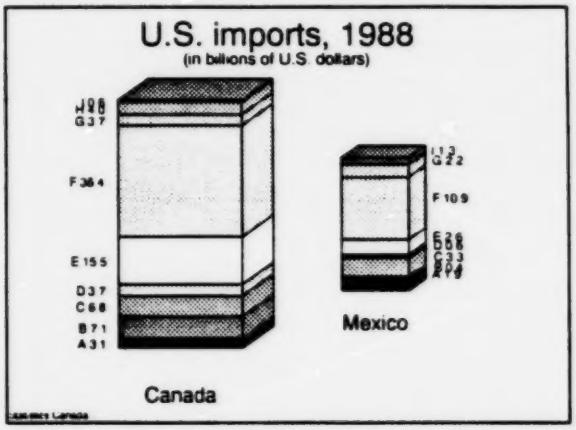
The drive to seek an improvement in economic relations with the U.S. predates the Salinas government. In 1987, the U.S. and Mexico concluded a framework agreement which established a comprehensive trade and investment consultative mechanism. An "Immediate Action Agenda" was also attached to the framework agreement which called for bilateral consultations to begin on the following sectors: textiles, agriculture, steel, investment, technology transfer, electronics, intellectual property, and services. This process led to the October 1989 doubling of the U.S. quota on Mexican steel and to the February 1990 agreement on textiles eliminating U.S. quantitative restraints on 52 types of Mexican textiles and increasing the quotas for 38 other categories. This agreement is expected to permit a 100% increase in Mexican textile exports to the U.S. over the next two years. Subsequently, petrochemicals, coffee, and beef were added to the list of sectors under discussion.



As for trade remedy actions, since 1984 only six U.S. anti-dumping investigations have been initiated against Mexican goods. There are only three Mexican products presently faced with the imposition of U.S. anti-dumping duties (elemental sulphur, cooking ware and cut flowers). The U.S. has, however, made greater use of its countervail laws against Mexico. Eleven Mexican exports presently are faced with countervailing duties with four more being the object of undertakings. As for Canada, anti-dumping duties are being imposed on imports of only one Mexican product, namely electric motors. Trade remedy actions have not, to date, been a major concern for Mexico.

Mexico's dependence on the U.S. market has grown significantly in recent years, growing from 52% of its exports in 1982 to some 73% in 1988. Indeed, Mexico's reliance on the U.S. market now rivals that of Canada. In contrast, Mexico's trade with Canada is quite small. The U.S. is the principal market for Mexico's manufactured (non-petroleum) exports. With the establishment of the maquiladora program in the late 1960's (under which U.S. firms are able to establish assembly plants and import components duty free and pay U.S. duties only on the value-added) Mexican exports of manufactured goods have risen spectacularly. The opening of the border has, however, led to a surge in imports in late 1989 and so far in 1990 that has led to predictions that Mexico may face a balance of trade deficit for 1990 as a whole.





The result and the definitive character of the extensive reforms that have been put in place by Mexico is probably best expressed by a quote from a Mexican Commerce Secretariat official: "In the end, we will have a completely transformed economy, a fully competitive exporting economy. There is no turning back from that aim."

LEGEND: **U.S. IMPORTS 1985 AND 1988**

A	Food and live animals
B	Crude materials, inedible, except fuels
C	Mineral fuels, lubricants and related materials
D	Chemicals and related products
E	Manufactured goods classified chiefly by material
F	Machinery and transport equipment
G	Miscellaneous manufactured articles
H	Commodities and transactions not classified
I	Sum of Beverages & tobacco and Animal & vegetable oils, fats & waxes

Indeed, the economic reforms already put in place coupled with those that have been announced will, in and of themselves, make the Mexican economy a more competitive force. Given the low level of the current U.S. tariffs facing Mexican exports[1], the primary effect of a free trade agreement with the U.S. will be to accelerate the restructuring process within Mexico and encourage investors to commit greater resources to Mexico.

III. Why the United States is interested

There would appear to be a number of complex reasons that drive the U.S. response to President Salinas' free trade initiative. The U.S. is eager to lock in the unprecedented market oriented reforms undertaken by the present Mexican government. The U.S. government recognizes that a free trade agreement could be an important element in improving Mexico's economic situation. This would, in turn, accelerate debt crisis recovery and may even pay dividends in terms of improved management of the drugs and immigration areas.

In economic terms, a free trade agreement with Mexico (a country with only one-twentieth of U.S. GDP) would provide only a very modest increment to the U.S. economy. Nonetheless, it is important for the U.S. that the Mexican economy be strengthened. The constant flow of immigrants (legal and illegal) places a burden on the social infrastructure of the Southern border states. As an export market, Mexico is the third largest single destination for U.S. exports totalling U.S. $20.6 billion in 1988. However, this is well behind U.S. exports to Canada ($70.9 billion) and Japan ($37.7 billion). If the EC were considered as a single destination ($75.9 billion), Mexico would be a distant fourth. Nonetheless, with a present population of 85 million projected to rise to 100 million by the end of the century, Mexico is potentially an important market for U.S. goods and one in which preferential access could be useful for U.S. exporters who already dominate. A North American economic grouping that included the U.S., Canada and Mexico would result in a market as large and populous as the European Community and the European Free Trade Association (EFTA) combined.

	GNP	Population
	U.S.$ billions	millions
EC plus EFTA	5,385	357
North America	5,528	355

1. According to the GATT Tariff Study (1988 data), the U.S. MFN weighted average tariff on agricultural products was 3.3% compared to 5.0% on industrial products. The weighted average tariff faced by Mexican goods would be lower than this given the eligibility of some Mexican exports for GSP treatment.

However, Mexico is the smallest, most protected and poorest of the potential parties to a North American economic grouping. It adds the least relative to the others (3.2 % of North American GNP and 4.5 % of total exports in 1988). In addition, there is a large disparity in per capita income between Mexico and its northern neighbours. When the EC incorporated Spain and Portugal, their per capita GNP levels at the time of accession (January 1987) were 51 and 24 % of average EC-10 per capita GNP. By comparison, Mexico's per capita GNP is only one-tenth that of the U.S. and one-eighth that of Canada. The challenges, therefore, are great, but the longer-term U.S. political (a more secure southern border) and economic interests (a prosperous Mexico that can provide jobs for Mexicans and markets for U.S. goods) could outweigh those challenges.

IV. What are the implications for Canada

Canada's trade relations with Mexico are very modest. Canadian exports to Mexico in 1989 were worth $603 million (less than half a percent of total Canadian exports; 17th most important Canadian export market). Our 1989 imports from Mexico totalled $1.7 billion, which represents just one percent of our total imports. The current average rate of duty on dutiable imports from Mexico is 10.6%. However, given that many Mexican goods are eligible for preferential rates under Canada's Generalized System of Preferences (GSP) for developing countries, and a large number of products already enter duty free, the average rate of duty on all imports from Mexico is 2.4%. The short term trade impact of increased access to the Canadian market for Mexican goods would appear to be limited.

From Mexico's perspective, Canada is a relatively more important trading partner than they are to us. Just as we do, however, they rely overwhelmingly on the U.S. as a market for their exports (73%) and as a source of imports (75%). In the course of North American trade liberalisation negotiations, Mexico would obviously concentrate its efforts on improving its access to the American market.

An important concern flowing from the creation of any free trade area is the risk of trade diversion for those countries not within the free trade area. A bilateral free trade agreement between the U.S. and Mexico could potentially result in the displacement of some American imports from Canadian sources by imports from Mexico. At the same time, Canadian firms would not have the same access as American firms to both Mexican inputs and markets.

The advantage for Canada in participating in a North American free trade agreement would be that it would ensure that Canadian producers have tariff free access to all three markets (both for exports and for the importation of inputs) on the same basis as U.S. producers, an important factor in ensuring that Canada remains a competitive base for investment. Some trade diversion concerns might still exist within a trilateral North American free trade area (also coupled with trade creation effects). However, given the small weight of Mexico in the North American economy (3.2% of combined GDP), it can be expected that a North

American free trade agreement would have only a modest short-term impact on Canada. Nonetheless, with adequate investment over the long term, Mexican exports could become competitive, not only in the labour-intensive textiles, apparel and footwear sectors, but also in consumer electronics and other assembly operations. While much of this may simply displace other low-cost sources, it will likely further encourage the restructuring of both the Canadian and U.S. economies towards higher value-added products.

As was the case in our negotiations with the U.S., Canada will have to pay attention to the rules of origin provisions of any agreement liberalizing North American trade. The problem most often mentioned is the potential use of Mexico as an location for Japanese "screwdriver plants". However, both Canada and the U.S. will likely be able to ensure that a basic amount of local value-added takes place before the product can benefit from FTA rates by establishing rules of origin along the lines of the Canada-U.S. FTA.

A. Impact on Canada's domestic market and on our export interests in the United States

It is essential to understand that, with or without an agreement to liberalize trade with Mexico, Mexican goods will become more and more competitive both in the Canadian and American markets as a result of the domestic reforms undertaken by the Salinas government. Mexican exports in a number of industrial sectors have increased significantly since 1985 even in the face of substantial tariff and non-tariff barriers to trade. Domestic reforms are already improving Mexico's international competitiveness; a trade liberalization agreement would marginally accelerate this process but would not radically alter it.

Following are assessments of the impact of further North American trade liberalization on four key industrial sectors.

1. Agricultural products

Mexico's vegetable and fruit exports to Canada reached $70 million in 1989 but, due to their earlier seasons, are for the most part not in direct competition with Canadian produce. North American trade liberalization could, however, have a ripple effect in the agricultural sector in general (e.g. pushing U.S. produce north). The additional competition faced by U.S. producers might lead to lower prices for Canadian consumers. A free trade agreement which included Mexico would probably not result in immediate change in the competitive situation of Canadian producers but could result in further adjustments within our horticultural industry over the medium term. Canada's **processed and semi-processed vegetable industry** (U.S. $48.9 million in exports to the United States in 1988) will also face greater competition from Mexican products in the U.S. market. Some of these challenges could be offset by greater export opportunities for Canadian agricultural goods in the Mexican market.

2. Energy and petrochemicals

While Mexico produces and exports many types of **petroleum products** which could compete with Canadian exports to the U.S., in most cases competition with Mexico is not an issue due to differences in crude quality and transportation networks which have resulted in the development of regional markets in North America which are supplied by different suppliers. Nonetheless, Mexico's sheer potential as a supplier of petroleum products would require the Canadian government to give particular attention to any U.S.-Mexico agreement affecting this sector in order to ensure that the U.S.market share of western Canadian production is not unduly affected. The direct impact of improved Mexican access to the Canadian market in coal, petroleum, and gas, would, however, appear limited.

CANADIAN TRADE WITH MEXICO
(Thousands of dollars)

	1989
TOTAL EXPORTS	**603,098**
Vehicles, parts & accessories	71,552
Iron and steel	71,324
Machinery & mech. appliances...	63,495
Oil seed, oleagi fruit;...	59,772
Dairy products...	46,404
Salt, sulphur; earth & stone;...	41,034
Aircraft, spacecraft, and parts	40,119
Pulp of wood...	23,819
Articles of iron or steel	20,627
	1989
TOTAL IMPORTS	**1,698,368**
Machinery & mech. appliances...	466,177
Electrical machinery equipment...	335,103
Vehicles, parts & accessories	299,415
Precious stones & metals, coins	199,528
Mineral fuels, oils...	49,406
Edible vegetables...	41,835
Edible fruits and nuts...	29,963
Coffee, tea...	26,507
Salt, sulphur; earth & stone;...	21,976
Articles of iron or steel	19,209

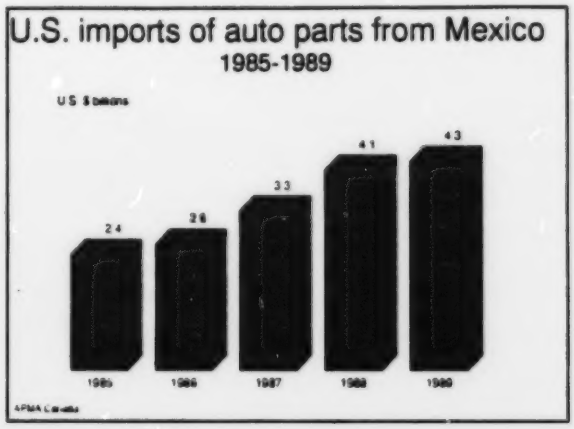
Source: Statistics Canada

The **petrochemical industry** is, however, becoming more competitive. Petroleos Mexicanos (PEMEX), the state-controlled oil company, still holds exclusive rights for the production of 20 basic petrochemicals. Seventy-five percent of the secondary petrochemical industry is, on the other hand, in private hands. Complete foreign ownership of firms in the secondary petrochemical industry is now allowed if the investor provides suitable technology or invests in a company which was facing international balance of payments problems. Further foreign investment in this sector could lead to increases in productivity with Mexico becoming a more important competitor for both Canadian and American producers.

3. Autos and parts

Canadian imports of Mexican automotive products amounted to approximately $299 million in 1989, and were comprised mostly of automotive parts and components. Exports of Canadian automotive products to Mexico amounted to $71.6 million in 1989 and consisted entirely of automotive parts. If other tariff line items are included, such as certain types of machinery, stereos and glass used in the production of vehicles, total automotive imports from Mexico

amount to about $680 million. Over 98 per cent of automotive imports from Mexico enter duty-free under the Auto Pact. The remainder are imported by non-Auto Pact companies at the GPT rate of six per cent.



The volume of U.S.-Mexico trade in automotive products is much greater. For example, U.S. imports of Mexican auto parts were well in excess of $5 billion in 1989. A substantial portion of these imports are manufactured under the maquiladora industry program, a border industrialization program initiated by Mexico in 1965. This program allows the duty-free entry of raw materials and components into Mexico on the condition they are exported as finished products. When the products are exported to the U.S., duty is, in effect, paid only on the Mexican value-added (since most of the components used are of U.S.-origin). The program is successful because it allows auto parts producers to benefit from low Mexican labour costs (about $1.50/hour) while maintaining near duty-free access to the U.S. market. It is estimated that approximately 200 auto parts manufacturers have established maquiladora facilities which produce mostly labour-intensive, low technology components. GM, Ford and Chrysler have established approximately 42 plants in the maquiladora region.

In effect, one way "de facto" free trade already exists between Mexico and the U.S. and Canada for automotive products because of Auto Pact privileges and the maquiladora industrialization program. As a result, Canadian parts producers and exporters already face some competitive pressures from labour-intensive, low-technology Mexican parts exported to Canada and the U.S. Various analysts have estimated that for selected components, the landed-cost advantage for Mexican parts in the U.S. and Canada is in the range of 5-15 per cent.

In 1989, a new Mexican decree was introduced (for implementation in late 1990) which would ease some of the current restrictions in that country on automotive trade and investment. It would, for example, abolish import licensing requirements and allow 50 per cent or more foreign ownership of domestic companies. It would also lower the Mexican content requirement from 60 to 36 per cent on average, making it easier for vehicle assemblers in Mexico to achieve higher levels of quality through the use of imported parts. The decree is considered an important incentive for automotive investment in Mexico, particularly in the area of high-technology, high-quality parts (a product segment where Mexico is weak), and in vehicle assembly. In essence, the measures of the new decree are designed to bring the Mexican automotive industry up to international levels of quality and competitiveness. However, these reforms will

still leave the Mexican industry with a high degree of protection. The complete removal of the remaining barriers would place the domestic Mexican industry (in particular their assembly operations for the Mexican market -- as opposed to parts production for export) under severe competitive pressures.

A free trade arrangement between the U.S. and Mexico would not significantly change the North American environment in which Canadian automotive companies compete. It might, however, have the effect of accelerating several trends which are already occurring in the industry, i.e., the growth of the Mexican automotive parts industry, increased sourcing of labour intensive, low-technology Mexican parts by North American companies, and further foreign investment in parts facilities in Mexico, particularly in the high-technology, high-quality parts segment, and increased competition from Mexican-manufactured vehicles. In terms of a Canada-U.S.-Mexico free trade area, as stated previously, virtually all Mexican automotive imports enter Canada duty-free, and therefore they would likely not significantly affect the status-quo in the short-run. On the export side, it is clear that competition from Mexican parts and components in the U.S. market will increase. To date, because of scale and infrastructure problems, Mexico has not moved into the assembly for export in a large way, but the possibility exists nonetheless. As for the Mexican market, some opportunities for additional direct exports of Canadian parts or vehicles may exist.

Whether a free trade arrangement is struck between the U.S. and Mexico or not, Canadian automotive vehicle and parts producers will likely be faced with increased competition in the 1990's from producers in Mexico (and if not Mexico, other low-cost suppliers in S.E. Asia or Brazil).

4. Textiles and clothing

Mexico is our third largest unrestrained supplier of textile products. However, because its exports are spread across a range of product categories, "market disruption" has so far not been a problem.

As a result of proximity to the U.S. market and the special U.S. outward processing programs, Mexico has developed a sizeable clothing sewing and processing capacity. The potential to take action under the Multi-Fibre Agreement (MFA) and the FTA rules of origin have probably limited the impact on Canadian producers from large scale imports of Mexican textile products or U.S. textile products further processed in Mexico.

In the case of textiles, Mexico's oil industry gives it a competitive advantage in the production of synthetic/man-made fibres. In this regard, Canada has, in the past, negotiated some voluntary arrangements with Mexico on their exports to Canada of polyester textured yarn and worsted spun acrylic yarn. The Mexican textile industry over the long-run may have possibilities for increased production.

Regarding the issue of increased competition in the U.S. market, the elimination of duties and other restrictive regulations of commerce (e.g. quota restraints) on Mexican textile and clothing products entering the U.S. would likely result in increased competition in that market for some Canadian exporters. This information must, however, be considered in relation to the present state of the Mexican industry. Its apparel industry is fragmented and dominated by small family-run sewing operations. The level of investment in the textiles sector has been low. The Mexican industry basically competes at the lower end of the U.S. apparel market (i.e., lower-cost commodity products) whereas Canada's competitive advantage generally lies in higher/less price-elastic apparel goods.

While Mexico's utilization of its guaranteed access levels in the U.S. market has been high, Canada and Mexico do not compete head-to-head in the U.S. market. This situation would likely continue in the medium term. In textiles, while Mexico does not appear to pose a threat to Canadian producers in either the domestic or U.S. markets, some potential exists for greater Mexican competition. However, with respect to clothing, given Mexico's likely concentration on the low end of the quality scale, they will most likely displace other low-cost producers in Canada and the U.S. rather than compete with Canadian goods.

B. Canadian export interests in Mexico

The volume of Canadian exports to Mexico has been relatively small over the years. Nonetheless, it appears that the Canadian business community does attach some importance to improving our access to the Mexican market. The Mexican market is considered as having considerable potential given its present relatively low level of development, its rapidly increasing population, and, most importantly, given the impact that the Salinas reform program is perceived as having on the Mexican economy. In the event of the successful negotiation of a trade agreement with Mexico, Canadian firms would likely wish to ensure that they are not disadvantaged relative to American firms operating in the Mexican market.

Canada's main export interests in the Mexico centre around the elimination of various quantitative restraints and import licensing requirements affecting a wide range of sectors (such as crustaceans, milk powder, oilseeds, newsprint, computer equipment and auto parts). Canadian firms have also found their export opportunities are restricted by Mexico's "Buy National" government procurement practices as well as various performance requirements on foreign direct investment (e.g. local content measures).

On a product by product basis, our export interests in Mexico would appear to be concentrated in sectors where Canada has traditionally benefitted from a comparative advantage. Our principal export interests have been identified in the following sectors:

- **Agricultural products:** live beef; beef, pork and horses meat; edible offal; and lard.
- **Fisheries products:** frozen fish; prepared or preserved fish; and crustaceans.
- **Minerals and chemicals:** asbestos; chemical fertilizers; nickel; aluminum (in all forms); magnesium; and bismuth.
- **Wood, pulp, and paper:** sawn wood; plywood; shakes and shingles; pulp of wood; fluting paper.
- **Iron and steel products:** rails.
- **Manufactured goods:** air conditioning machines; certain machine tools; ball or roller bearings; electrical transformers; telephonic switches; colour cathode tubes; mattresses and bedding articles; and lamps & lighting fixtures.
- **Public transit equipment:** subway and rail cars.

C. Financial services

1. Proposed Financial Sector Reforms in Mexico

All Mexican banks are nationally owned with limited (if any) direct involvement by foreign institutions. Also, there is no foreign participation in the securities industry and only a limited foreign presence in insurance.

Earlier this year the Mexican government announced that it would relax certain foreign ownership restrictions through the following measures:

- With respect to national banks, foreign ownership in any one bank will be permitted up to a maximum of 34% of non-voting shares.
- In insurance, up to 49% foreign participation would be permitted, with Ministerial approval.
- Foreign participation in exchange and securities firms will continue to be barred.

On May 2, 1990, President Salinas announced the re-privatization of Mexican banking system (the banks were nationalized in 1982). The Mexican government proposes the establishment of a mixed regime but has not identified which banks will be privatized nor the amount of the government's shareholdings which will be put up for sale to domestic and foreign investors. It is assumed that the big development banks (Nafinsa and Banobras) will remain state-owned.

2. Trade in Financial Services with Mexico

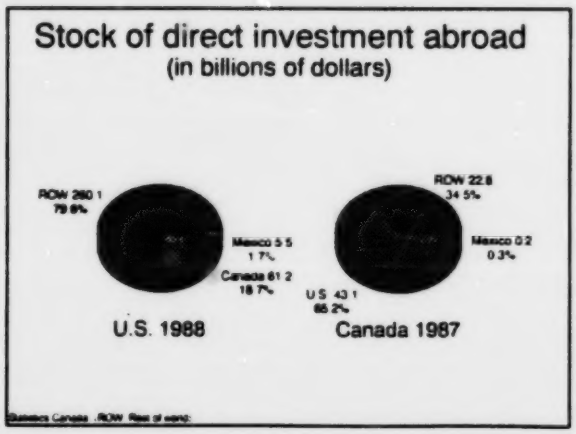
Mexican institutions have no presence in Canadian financial markets. Likewise, there are no Canadian financial institutions operating in Mexico, to our knowledge, either on a branch or subsidiary basis. Some Canadian banks have Mexican representative offices used for marketing purposes solely. Also, while affiliates of foreign-owned Canadian insurance companies operate in Mexico, this has no bearing on Canadian firms. Aside from syndicated loans to Mexico (which grossed $4.5 billion for all Canadian banks in October 1989), there does not appear to be any other direct dealing by Canadian financial institutions in Mexico.

3. Potential Implications of U.S.-Mexico Deal

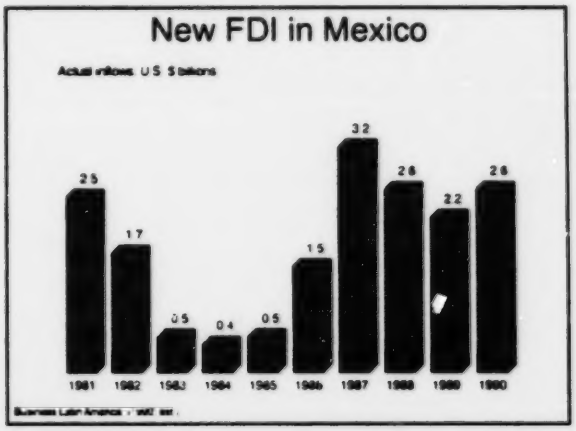
There would not appear to be any major implications from trade liberalization between Mexico and the U.S. for Canadian financial institutions. Any increase in trade, however, is likely to result in greater opportunities for Canadian financial institutions to service the companies involved in that trade. The resultant stimulus to Mexico's economy under a free trade deal would lead to a higher volume of trade financing with Mexico over time.

V. Potential long term impact on investment flows

The previous sections of this paper indicate that the actual short to medium term impact of further North American trade liberalization would have only a limited effect on Canada's trade with the U.S. and Mexico. However, there could be potential for increased competition between Canada and Mexico as foreign direct investment (FDI) recipients, either as a result of a bilateral U.S.-Mexican agreement or a trilateral agreement including Canada.



The reforms undertaken by the Salinas government have already had an impact on the perception of the private sector of Mexico as a potential location for FDI. The liberalization of the autos & parts industry, for example, has led to large new foreign investments in Mexico which have greatly improved the country's competitiveness in that sector. Such inflows of investments are bound to continue as foreign firms, spurred on by the economic reforms of the Salinas government, decide to take advantage of Mexico's relatively low labour costs and natural resource base (particularly to its petroleum and gas resources). The resumption of the debt for equity swap program is also expected to increase FDI in Mexico. It can therefore be expected that, independently of any trade agreement, other industries will eventually benefit from an influx of foreign capital brought about by the Mexican government's reform program. The impact of a U.S.-Mexico FTA would reinforce the effect of the reforms discussed above and would make investing in Mexico, particularly in the autos & parts and textile & clothing, even more interesting for both U.S. and third country firms.



An important issue from Canada's perspective is to what extent Canada actually competes with Mexico as a location for FDI by firms wishing to service the North American market. Firms base their decision to invest abroad on 1) the size and growth of the foreign market, 2) the costs of production and distribution, 3) the nature of competition involved, and 4) government attitude to business (i.e. fiscal, commercial and regulatory policies). In the event of the creation of a North American FTA, a firm deciding where to locate in North America would base its decision on a comparison of Mexico and Canada's relative advantages with regard to factors 2) and 4).[2]

Canada is not threatened by the possibility that high distribution costs will divert investments to Mexico. Canada's infrastructural links with the U.S. market and its established distribution networks provide considerable assurance that distribution costs will remain competitive in most sectors. The north/south regionalization of market shares already apparent in certain sectors of the U.S. market (e.g. Canadian firms supplying the northern tier states while Mexican firms concentrate on the southern tier) could become even more marked as a result of a North American FTA. Such a phenomena is, however, the natural result of geography and transportation links and a North American FTA would only accelerate what is already taking place.

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2. Factors 1) and 3) have less impact on the location decision within a given region but will greatly influence the inter-regional decision (ie. whether to invest in North America or Europe).

Mexico has a definite advantage over Canada in terms of wage rates but these constitute but one component of actual production costs. The availability of specialised labour, the research and development infrastructure, the access to financial, professional and other types of services, even the types of services provided by the different levels of government, have direct or indirect impact on the actual cost of production and productivity of a firm. The differences between Canada and Mexico in terms of all of the above factors are significant and likely contribute to higher overall Canadian productivity which, in a number of sectors, compensate for the higher Canadian wage rates.

It can be argued that Canada and Mexico compete for FDI in North America on the basis of different comparative advantages and that an FTA will therefore not have a significant diversionary impact on foreign direct investment. The Canada-U.S. FTA was part of the government's strategy to accelerate the adjustments within Canada and the restructuring of our economy towards higher value-added production. A North American free trade agreement would simply reinforce the importance of such restructuring.

VI. Conclusions

Mexico is clearly undergoing a massive economic transformation towards becoming an outward-oriented, market-based economy. Since 1986, when Mexico joined the GATT, it has significantly liberalized both trade and investment and has embarked on an important program of privatization. The Salinas government has accelerated this pace of change and is seeking to maintain the momentum of economic reform by reaching a trade agreement with, in particular, the U.S. The U.S. has become over the past decade Mexico's predominant market and, as Canada, it is logical for Mexico to seek to obtain secure market access to the U.S.

The U.S. also has strong interests in promoting Mexican economic growth. A stronger Mexican economy would accelerate the repayment of debt, bolster democratization, ensure a more secure southern boundary, and could pay dividends in drug control and immigration areas. A free trade agreement would also go a long ways towards locking-in the unprecedented economic reforms being put in place by the Salinas government. U.S. exporters have an interest in the Mexican market, especially a growing and more affluent one.

For these and a host of other domestic and geopolitical reasons, it would appear that the study process initiated on June 10 by Presidents Bush and Salinas will develop into the launching of negotiations on a "freer trade agreement". Given the difference in economic levels of development and the past history, the negotiation of a free trade agreement will not be an easy process for either the U.S. or Mexico. Both countries will seek to protect their sensitive sectors and there may be difficulties in dealing with labour mobility (potentially an important goal for Mexico).

Canada's interests in becoming involved in a freer trade arrangement involving both the U.S. and Mexico are a little more complex and indirect. In terms of exports, Canadian exporters see real potential in the Mexican market, although the immediate benefits are not likely to be large. The import impact of freer trade with Mexico would appear to be varied, but in general there are likely to be only marginal concerns over the short-term. In addition, given increased globalisation and the likelihood of reduced tariffs flowing from the Multilateral Trade Negotiations (MTN), Canada will face increased competition in the U.S. market from Mexico and other low-cost producers regardless of a free trade agreement between the U.S. and Mexico.

Consequently, the real question for Canada is how it can best position itself to remain competitive in the North American and world market over the medium to long term. As industries restructure in order to adapt to the competitive pressures, whether from Mexico or elsewhere, it will be important that firms located in Canada are perceived to have access to the same markets as firms located elsewhere in North America. Participation in a trilateral free trade agreement would allow Canadian producers to have access to the entire North American market both as exporters and importers on the same basis as American producers. This will assist in ensuring the continuation of the current adjustment taking place in Canada towards higher value added production and that Canada maintains its competitiveness as a host for new investment.